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Alan Greenspan the Contrarian

Greg's Note: Our pal Frederick Sheehan examines Pimco's decision to have Greenspan on as an advisor. Could he be their contrarian indicator? Fred takes a look at the Maestro's past track record. Also, Fred is completing a biography of Alan Greenspan. Stay tuned for more about Fred's book. Please send any opinions to your managing editor here: greg@whiskeyandgunpowder.com

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By Frederick J. Sheehan

Help Wanted: A Leading Contrarian Indicator

"Alan Greenspan will advise…Pacific Investment Management Co. on strategy during quarterly economic forums, said Foong Hock Meng, head of Pimco's Singapore office.

"Greenspan, 81, will join Bill Gross, Pimco's chief investment officer who also manages the $100 billion Total Return Fund for the Newport Beach, Calif.-based company.

"'This engagement provides Pimco with unique access and insight from the former Fed chairman, whose perspective on financial markets, global economic trends, and investor behavior is truly special,' Foong said."

-- *Bloomberg,* May 16, 2007

Bill Gross has admitted to confusion in recent months. Interest rates are not behaving as they should. In such a circumstance, employing an abysmal forecaster might add just the contrarian indicator that he needs. This is one possible duty for his new hire. On the other hand, Alan Greenspan's generous press clippings may have led Pimco to a false reading of its recruit's aptitude.

We might start with his earlier term in the federal bureaucracy. He served as President Ford's chairman of the Council of Economic Advisers from 1974-1977. To read the press of the day, Greenspan was magnificent. By early 1975, a "top White House official" told *BusinessWeek:* "Greenspan has a unique personal relationship with the president." The unnamed insider said that on "economic policy Alan is a heavyweight." According to *BusinessWeek:* "Greenspan spends much of his time screening economic information to determine what gets to the president, and the quality of the material is considered 'first-rate' by White House insiders."

This 1,600-word profile of the CEA chairman informed readers that:

"Greenspan's special skill as an economist is his ability to quickly recognize the changes occurring in the economy, to understand their significance, and to make the necessary adjustment. Such skills, which Greenspan honed to a fine edge as private consultant to the top executives of about 100 of the country's biggest corporations, were particularly important in recent months when the economy was collapsing with bewildering speed."

Confirmation of his skills flowed from all quarters. President Ford's Chief of Staff Richard Cheney (known to us as "Dick"), claimed the president attached "more weight to Greenspan's views than to those of any other economist."

Yet the public record calls Greenspan's skills as an economist into question. On Sept. 5, 1974, the day after he was sworn in as head of the CEA, Greenspan announced: "We are not about to get a dramatic decrease in economic activity." With this knowledge, he urged President Ford to propose a tax surcharge -- an effort to halt inflation. This was exactly the wrong time for such a tactic (which was passed into legislation). The economy contracted 5.8% from mid-1974 to mid-1975.

In April of 1975, when *BusinessWeek's* glowing profile was published, Greenspan warned a New York audience that the worst was yet to come. In fact, the worst had passed. According to the National Bureau of Economic Research, the recession ended in March of 1975. In the fall of 1975, Greenspan coordinated the "Whip Inflation Now" conference in Washington, participants donning WIN buttons to battle a foe that had already, at least temporarily, diminished as the leading economic problem. (Consumer price inflation fell 75% between the summer of 1975 and the spring of 1976.) If the CEA chairman did set President Ford's economic policy (as his chief of staff and the press would have us believe), this may have made the difference in Ford's slim 1976 presidential-election loss to Jimmy Carter.

Alan Greenspan's nomination hearing for Federal Reserve chairman provided another opportunity to review his skills. He appeared before the Senate Committee on Banking, Housing, and Urban Affairs on July 21, 1987. It was chaired by Sen. William Proxmire of Wisconsin. Proxmire chided the candidate for a "dismal forecasting record" when he was chairman of the CEA. Proxmire reviewed the forecasts made by the Council of Economic Advisers between 1976-1986. The senator was particularly interested in those made during Greenspan's chairmanship of the CEA.

Proxmire evaluated the forward projections made during Greenspan's term for 1976, 1977, and 1978. In Proxmire's words, the forecasts made by the candidate were "way off." Of the interest rate forecasts made by the Counsel of Economic Advisers (for the years 1976-1978), Greenspan's were wrong by the biggest margin of any of the 11 years…Proxmire went on: "There you broke all records for the entire period in error." The man whose opinions President Ford weighed more heavily than "those of any other economist" had prophesized the Treasury bill rate would be 4.4% in 1978. It was 9.8%.

Of inflation: "There again, you broke all records." The only CEA chairman to adorn the front cover of Newsweek estimated the consumer price index would rise 4.5% in 1978. It soared 9.2%.

In later years, Greenspan would control such quibbles; not this day. He replied to Proxmire: "That is not my recollection of the way the forecasts went." Proxmire held the forecasts in his hand and read the date to Greenspan. The candidate admitted: "Well, if they're written down, those are the numbers."

The transcript follows:

PROXMIRE: Yes.

GREENSPAN: There is a very substantial difference, Senator, between forecasting in the administration and forecasting outside.

PROXMIRE: I should hope so!

Greenspan then embarked on the gobbledygook so familiar in later years. Proxmire waited patiently and then responded:

PROXMIRE: Every one of the chairmen of the Council of Economic Advisers had the same problem, and they didn't miss by as much as you did, not nearly as much…

GREENSPAN: I feel sorry for me and happy for them.

Proxmire went on to ravage Greenspan's record as a private forecaster. The repartee might be compared to the 1962 Yankees mowing down the 1962 Mets. (Proxmire and his staff must be commended for such a thorough search through the Greenspan archives. During the 18 years of Greenspan's term, the press never exhibited such energy. Proxmire retired in 1988, so we will never know what might have been.)

The transcript shows no collateral interest by the other senators. Each had his own line of advance, but Proxmire was the only one who thought it worthwhile to judge the potential future Federal Reserve chairman through his past performance. Proxmire, observing his fellow senators were not particularly interested in this *tete-a-tete,* drew to a close:

PROXMIRE: I hope…when you get to the Federal Reserve Board, everything will come up roses. You can't always be wrong.

GREENSPAN: All I can suggest to you, Senator, is that the rest of my career has been somewhat more successful.

Oh, if only it were true. He made, perhaps, the least timely forecast of his career on Jan. 7, 1973. He told *The New York Times* that he was highly optimistic and announced: "It is rare that you can be as unqualifiedly bullish as you can now." The Dow Jones industrial average peaked at 1,051 four days later and never looked up until it bottomed at 571 on Dec. 12, 1974, a loss of 46%. The dollar lost 21% of its value against the consumer price index over that period.

Enough of the old days. We will skip to the end. A full listing can be dreary. However, to give the distinguished economist -- that is, Proxmire -- credit for all he feared, we drop in on a news conference on July 10, 1991. The Maestro spoke: "I think the evidence is increasing week by week that the bottom is passed and the economy is beginning to move up...I think it's a pretty safe bet at this stage to conclude that the decline is behind us and the outlook is continuing to improve." The decline was still putting on its ski boots.

Greenspan topped out on Feb. 23, 2004. He addressed the Credit Union National Association in Washington. The chairman of the Federal Reserve Board tried his best to convince Americans their best interests were served by grasping for the highest priced houses by means of the riskiest loans. He opened his pitch by noting, "American homeowners clearly like the certainty of fixed mortgage payments." He advised insulated Americans to look overseas: "This preference is in striking contrast to the situation in some other countries, where adjustable-rate mortgages are far more common…Fixed-rate mortgages seem unduly expensive to households in other countries." He informed his constituents the "traditional fixed-rate mortgage might be an expensive method of financing a loan." He advised they refinance. Refinancing generally exploited two tendencies -- **1)** the lower monthly payment of a variable rate mortgage and **2)** a higher valuation of the house. The combination of the two often took the form of refinancing at a higher level of principal.

Only a month later, Greenspan told the New York State Economics Association that rates would rise at some point. On June 30, 2004, the Federal Reserve raised the federal funds rate. Once the Fed started to raise rates, the trusting adherents to the Book of Greenspan were doomed. (It is to be hoped advice from Greenspan's quarterly monologues does not discourage Pimco mutual fund returns.)

On Oct. 26, 2006, the retired chairman announced the housing slump is "likely past." Exactly one week later, this opinion was expertly choreographed into a National Association of Realtors $40-million advertising campaign. The full-page newspaper ads were titled: "It's a Great Time to Buy or Sell a House." Greenspan contributed to the sales pitch by assuring us that the fourth quarter (of 2006) will "certainly be better than the third quarter."

Notably, not a single mortgage lender had surrendered at the time of this upbeat forecast. In the wake of this reassurance, 66 mortgage lenders have entered bankruptcy. Last fall, "subprime" was a poor cut of meat to most Americans. Now, Congress investigates why no one at the Federal Reserve forewarned of this problem.

To conclude (with difficulty, as the field is so broad), the subprime market received a rousing endorsement from Greenspan on April 8, 2005. The head of the Fed -- who is also the nation's leading bank regulator -- announced:

"With these advances in technology, lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers…Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants and to price that risk appropriately. These improvements have led to rapid growth in subprime mortgage lending."

An epitaph would try the patience of the reader. Pimco's evaluation is correct in one respect: The former chairman's perspectives are truly special.

Regards,
Frederick Sheehan